

CALIFORNIA STATE TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: External Equity – Equity Monitoring Policy

ITEM NUMBER: 8

ATTACHMENT(S): 2

ACTION: X

DATE OF MEETING: June 2, 1999

INFORMATION: _____

PRESENTER(S): Ms. Okada
Ms. Hester Amey

Executive Summary

One of the 1998/99 objectives approved for the Investment Branch was to complete a policy document for the monitoring and evaluation of equity investment managers and portfolios, employed by CalSTRS in the fulfillment of the goals of the Investment Management Plan. The equity asset category consists of investments in domestic and international equity securities. The equity asset category is managed with the use of both External Investment and Internal Investment Management: The passive style of investment management is managed by both internal and external managers. The active style of investment management is managed solely by external managers. All external managers enter into a contract with CalSTRS. This contract includes investment guidelines that detail the investment parameters and performance benchmarks for each manager. The internal investment manager's parameters and benchmarks are identified in the Internal Equities Policy document.

The policies are designed to establish guidelines for portfolio structure and to identify clear performance objectives, benchmark selection, tracking error, portfolio composition, style characteristics, portfolio restrictions and trading activities. Policies are static in nature and will not be altered without the review and approval of the Investment Committee.

Recommendation

Staff recommends that the Investment Committee approve the revised policies for the equity asset category by adopting the attached resolution, labeled Attachment 2.

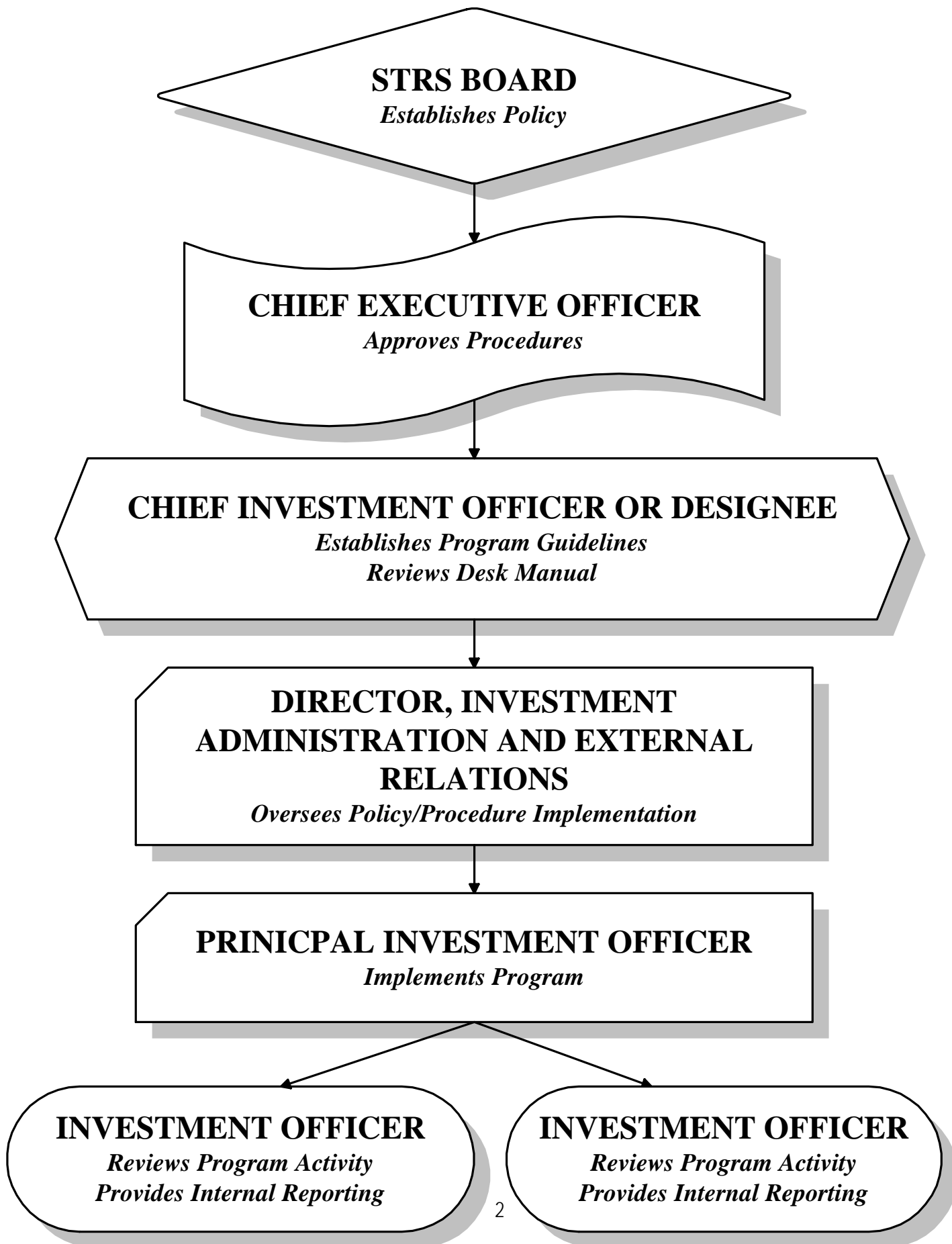
CalSTRS

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

EQUITY MONITORING POLICY MANUAL

INVESTMENT BRANCH
June, 1999

Equity Monitoring FLOWCHART



Introduction

In accordance with the Investment Management Plan, the California State Teachers' Retirement System (CalSTRS) has established an allocation for the equity asset category. CalSTRS requires a policy document to guide the monitoring and evaluation of this asset category. This document is designed to establish guidelines for portfolio structure and to identify performance objectives. In order to insure compliance with investment guidelines and performance objectives, staff assiduously monitors the equity portfolios.

Policies are designed to establish guidelines for portfolio structure and to identify **performance objectives**. Procedures supply a blueprint for the flow of information between the internal and external managers and the External Equity Unit of STRS.

The policies established by STRS' Investment Committee are designed to promote adherence with accepted fiduciary practices. Policies are designed to provide a foundation to be followed. Changes to the policies will be presented to the Investment Committee for review and approval. Procedures are designed to be dynamic in nature with modifications expected to occur as the marketplace or the External Equity Unit changes.

EQUITY MONITORING POLICY

The following represents policies used in the administration and management of the Equity portfolio segment. The policies are designed to establish the basis for performance expectations and portfolio structure, while creating investment guidelines for equity managers. As with all other plan assets, these policies cannot be altered without explicit direction from the Teachers' Retirement Board (TRB).

1. **LAWS AND STATUTES:** The equity portfolio segment of the California State Teachers' Retirement System (CalSTRS) is to be invested, administered and managed in a prudent manner for the sole benefit of the CalSTRS participants and beneficiaries, in accordance with the Teachers' Retirement Law and other applicable State statutes.
2. **REGULATIONS:** For domestic equities, the asset category will comply with the rules of the Securities and Exchange Commission (SEC), equity exchanges, and other regulatory agencies. For non-U.S. equities, the asset category will comply with the appropriate regulatory body in the respective country.
3. **ASSET OBJECTIVE:** The asset category shall be managed to achieve optimum performance results, diversification of styles and assets, clear and certain disclosure and accountability. Each portfolio will be managed to a certain benchmark, clearly stated in the portfolio manager guidelines and monitored by the External Equity Unit.
4. **DELEGATION OF AUTHORITY:** The Chief Investment Officer (CIO) or designee has the authority to manage the equity asset category and may use other investment personnel to implement these policies.
5. **DECISION MAKING AUTHORITY:** The decision regarding a specific investment manager is delegated to the CIO or designee within the boundaries established by these policies.
6. **COMPLIANCE PARAMETERS:** Manager guidelines, objectives, benchmark selection, tracking error, portfolio composition, style characteristics, portfolio restrictions, and trading activities are to be monitored across all Equity portfolios. All investment instruments and/or activities shall be governed by the Investment Resolution adopted by the TRB on October 19, 1984, and amended as required.
7. **MONITORING and REPORTING:** The External Equity Unit shall report on compliance results to the CIO or designee, quarterly. It is expected that compliance reporting will be ongoing and continuous.
8. **TRANSITION MANAGEMENT:** The External Equity Unit will prudently administer and liquidate, if advisable, the existing portfolios of managers that have been relieved of investment management responsibility for CalSTRS.

9. **MANAGER POOL:** CalSTRS shall maintain a pool of managers to supplement the existing managers or to replace a terminated manager. The monitoring and reporting associated with the manager pool will be consistent with policy #7.
10. **ANNUAL BUSINESS PLAN:** The External Equity Program will be managed in accordance with a business plan, which will be prepared on an annual basis and will describe CalSTRS' objectives for the coming twelve month period.
11. **AUTHORITY LETTERS:** Authorization letters regarding the transaction of CalSTRS' External Equity Program business will be provided to staff, external investment managers and brokers. Whenever there is a change in authorized personnel, a written notice shall be provided to each affected party, within 48 hours.
12. **BOARD REVIEW:** The TRB or the Investment Committee may review this policy periodically, as deemed appropriate and in keeping with its fiduciary standards.

GLOSSARY

- **Active Management** - The active manager attempts to add value by intentionally deviating from the characteristics of a passive benchmark index. These deviations attempt to select superior issues that will produce a higher return than the index. Higher risk usually accompanies active management.
- **Basis Point** - One hundredth of one percent or .0001 in decimal form.
- **Benchmark** - A yard stick that is used to track the performance of an active portfolio or an investment vehicle that is used to create a passive portfolio.
- **Best Execution** - Refers to executing Client transactions so that the Client's total cost is the most favorable under the particular prevailing circumstances at that time.
- **Broker** - Refers to a person or entity registered with the National Association of Security Dealers and provides investment services (research, soft dollar, etc) and/or execution services.
- **Commission Rates** - Fee paid to a broker for executing a trade. The fee is based on the number of shares traded, the dollar amount and the liquidity of the trade.
- **Diversification** - Refers to spreading the risk of an asset category by assuming similar management styles to an appropriate benchmark.
- **General Consultant** - A consultant that addresses questions concerning general types of investments such as equity and fixed income for both domestic and international securities.
- **Growth Style** - This style of investment constructs portfolios that have more earnings potential than the benchmark and therefore have the potential to produce superior returns over the benchmark. These portfolios generally exhibit more risk than the benchmark.
- **Indexed Portfolio** - This type of portfolio is structured to replicate a specific index. The objective is to generate a portfolio that will produce the same return as the index at the same level of risk as the index.
- **Investment Guidelines** - This is a document that establishes the parameters through which the investment manager will invest STRS' assets. These guidelines specify valid securities for the portfolio, the return expected from the manager, how the manager will be evaluated and the period over which the manager will be evaluated.
- **Investment Management Plan** - This document outlines STRS' general and financial objectives including specific investment strategy. This document is the result of studies that include the assets and liabilities for the System.

- **Large Capitalization Style** - Refers to the investment process that includes a range of style, from value to growth, that provide active management using large capitalization stocks.
- **Liquidity** - Refers to availability of a stock to be traded. An issue that is readily available is considered to be liquid, an issue that does not trade very often is deemed illiquid.
- **Passive Management** - Refers to the maintenance of a portfolio whose goal is to replicate the return and risk characteristics of the desired index.
- **Percentile** - A percentile is 1/100th of the whole. As used here, it is the rank of a manager's investment performance compared to a universe of its peers. For example, if a manager ranks in the 7th percentile, then the manager's performance is higher than 93% of the other managers in the universe.
- **Performance Objective** - Refers to each individual external managers' designated benchmark (example, S/P 500) and their performance target (example, S/P 500 + 2%).
- **Pool Managers** - Refers to investment managers who have been selected to take the place of funded managers that may be terminated. The pool managers will correct any imbalance caused by the termination of a manager and quickly correct possible unintended bets or tilts.
- **Request For Proposal** - Refers to a search and selection process for hiring external money managers. The process provides minimum qualifications, description of duties, and a detailed questionnaire to be completed by the proposer. Selection is based on the firm's investment process, personnel, performance and fees.
- **Section 28e** - “Safe Harbor” Refers to a section in the Security and Exchange Act that provides a safe harbor (in good faith) against claims of breach of fiduciary duty for investment managers using brokerage commissions generated by customer orders to obtain brokerage and research services. Section 28e also addresses whether a product or service provides lawful and appropriate assistance to the investor in the performance of its investment decision-making responsibilities. It also clarifies the application of the safe harbor to third party research, emphasizes the importance of written disclosure of soft dollar arrangements to customers and reiterates the manager's duty of best execution.
- **Sector** - The market is segmented into sectors such as Energy, Finance and Consumer Durable.
- **Small Capitalization Style** - Refers to a investment process that includes a range of styles, from value to growth, that provide active management using large capitalization stocks.
- **Soft Dollars** - Refers to the use of brokerage commissions to pay for research and other services that are investment related.
- **Tracking Error** - The amount of return that the portfolio differs from the targeted index. This difference could be positive or negative.

- **Universe Comparison Services** - Refers to a service that groups style (growth/value/neutral) and capitalization (small/large/medium) of a large number of funds and provides performance rankings of each group.
- **Turnover** - In reference to securities, it is the percentage that the portfolio is traded on an annual basis. It is calculated by dividing the smaller of purchases or sells by the total value of the portfolio.
- **Value Style** - Refers to the investment process, which seeks to identify present value rather than future rewards, select stocks that will maintain their price in falling markets or periods of economic uncertainty, and look for stocks that are undervalued, but fundamentally strong.

PROPOSED
RESOLUTION OF THE
CALIFORNIA STATE TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: Equity Monitoring Policies

Resolution No. _____

WHEREAS, the Investment Committee of the California State Teachers' Retirement Board is responsible for recommending to the Board, investment policy and overall investment strategy; and

WHEREAS, the Investment Committee has received and reviewed the Equity Monitoring Policy and has heard oral presentations from Staff; and

WHEREAS, the Staff has recommended the adoption of the Equity Monitoring Policy; Therefore be it

RESOLVED, that the Investment Committee of the California State Teachers' Retirement Board adopt the Equity Monitoring Policies.

Adopted by:
Investment Committee

On _____

James D. Mosman
Chief Executive Officer